RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038
26 LETTERS PER YEAR • $225 ANNUALLY

**June 27, 1984** **LETTER 890**

June 15 DJIA 1086.90; PTI 1570; A-D Ratio -22.96
June 22 DJIA 1131.07; PTI 1582; A-D Ratio -21.33

**PREAMBLE:** In the June 20 WSJ Vermont Royster explains why, despite the nation's horrendous deficit, it is a political impossibility to cut Social Security and most of the other fat entitlements that the nation has voted for itself. I agree. In my opinion, it is going to take an economic collapse and possibly a depression before people realize that the current US economic trend is self-destructive.

Up to now, inflation has been the way out. Deficits have been handled by "printing more." I believe that "escape by inflation" has about ended. The next path that the politicians will follow (in my estimation) is "escape by higher taxes," which (like inflation) is just another method of taking money away from the citizenry. Finally, the forces of the market will have their say. That's when things will get done. But economic blood will flow first.

**THE MARKET:** On June 15 the D-J Industrial Average hit a low close value of 1086.90. Bear market closings were recorded by many other widely followed averages such as the D-J Utility Average (122.25), the D-J 65 Stock Average (423.88), the NYSE Industrial Index (101.26), the NYSE Finance Index (79.00), the NYSE Composite (86.17), the S & P Industrials (169.26), the S & P Transportation Index (121.21), the S & P Financials (14.71), the S & P 500 Index (149.03).

The important non-confirmation was the D-J Transportation Average, which closed the day at 458.02, better than 3 points above its previous 1984 low close of 454.53.

There are two points to consider here. The first is that under Dow Theory a penetration by one Average unconfirmed by the other is not a valid prediction of future price direction. Therefore, the fact that the Transports refused to confirm the new low in the Industrial Average was a plus for the market—at least over the near term. The market celebrated that fact with a spirited rally the next day, a rally which saw the Industrials climb 22.75 points. The rally continued through the week.

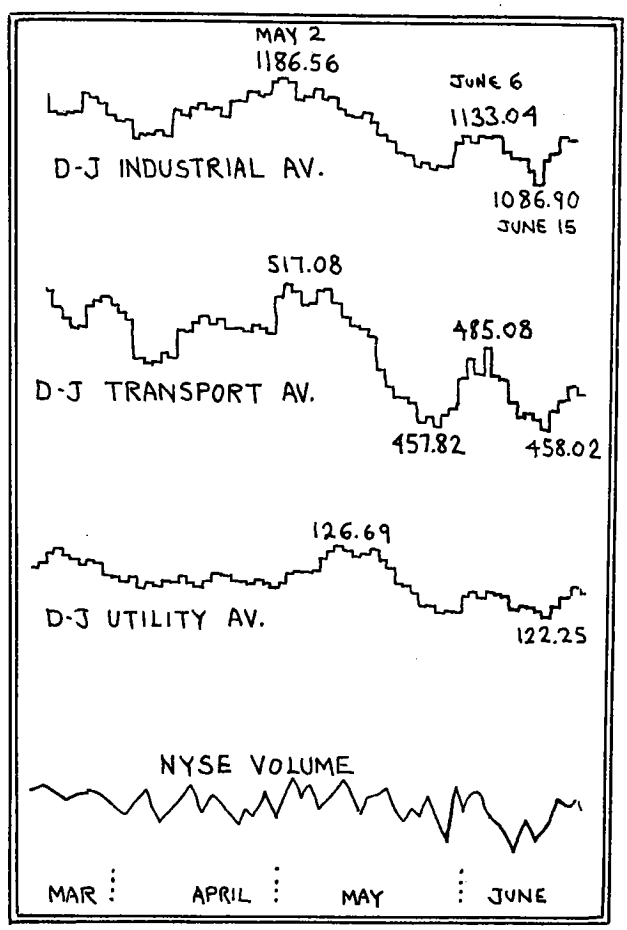
The other longer-term Dow Theory concept is this: a trend, once established, is taken to CONTINUE until proved otherwise. The last confirmed trend in the market was bearish, and until proved otherwise that is the way we will view this market—as bearish for the primary trend.

Throughout 1984 my Primary Trend Index (PTI) has been of real help. In earlier Letters I made use of point & figure work with the PTI to project a downside target for the PTI of 1568. On June 15 the PTI recorded a 1984 low of 1570, just 2 points above my minimum target.

*Near Term:* From its 1984 high of 1787 the PTI (as of June 15) lost 217 points, a very severe drop by any reckoning. Furthermore, the PTI (see page 2 chart) has not had a rally worth talking about during all of 1984. At its June 15 low the PTI was a whopping 94 points below its 21-week Moving Average (MA). The spread between the PTI and its MA seldom gets wider than this, and based on the spread alone I would think that this is rally time.

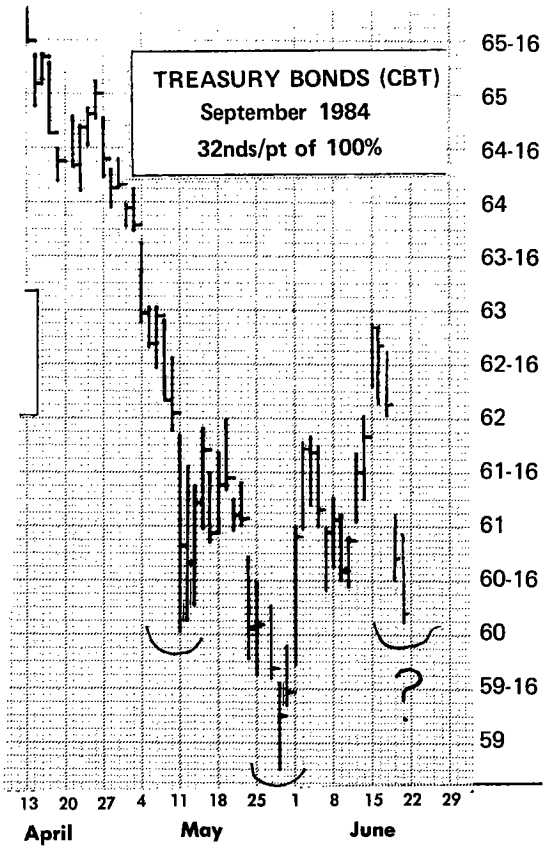
So far, the rally from the June 15 lows has been unusual in that the number of issues participating has been sub-standard. This is seen in the anemic rise in the A-D ratio. The PTI, too, has been reluctant to surge. However, many advances start with deceptively feeble rallies, so we must give the market its head.

Probably the best gauge of whether this market is going anywhere on the upside is the ability of the Industrials and Transports to climb above their June 6 highs of 1133.64 and 485.08 respectively. A bettering of those two points would be the biggest plus in the technical structure of the market since the highs.



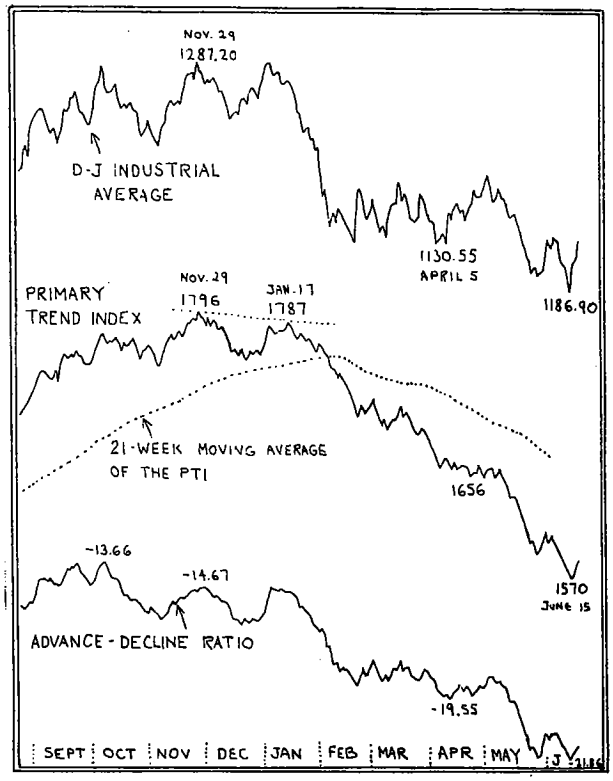
A second area to watch is seen on the PTI. A trendline drawn through the January and May peaks comes in at roughly 1606–about 20 points above the current level. A reversal of this trendline would constitute an important secondary bullish signal on my work.

Following up the bond discussion in the last Letter, the bond futures have now formed a head-and-shoulders bottom on the charts. Wall Street is hoping to heaven that this represents an important bottom. It is going to take time to see whether this bottom holds. If it does, then it follows that interest rates have seen their peak–at least for the foreseeable future. And the stock market would like nothing better. Remember, the stock market can live with high interest rates, but it can not live with steadily rising rates. So Wall Street's eyes are fixed on that chart. In fact, you could probably call this the KEY chart in the US today (chart courtesy of Dunn & Hargitt).




**WHEN AND HOW LOW?:** The most frequent questions asked during a bear market are "How long will it last?" and "How low will the market go?" Obviously, no one has the answer to these crucial questions, and that is exactly why I adhere to classic Dow Theory procedure during a primary bear market. The procedure is to "get out" while the bear is in control; "Get out of the stock market and get into short-term money instruments such as T-bills."

In the last Letter I included a study by Bill Menker regarding the year-to-year change (momentum) in the Standard & Poor's 500 Stock Index. It was shown that following a major rise in momentum, whenever the momentum index turned down and broke below the zero line it has taken the S & P 500 anywhere from 4 to 19 months to hit final bottom (average of the last 9 instances was 9 months).




To update this study, the momentum index broke decisively below zero last month–in May 1984. Following last month's break, if the S & P requires its 9-month average time to hit bottom that bottom will occur in February 1985. If it requires its shortest previous times (4 months) to hit bottom we can look for the final low in September 1984.

I also noted in the last Letter that the advance-decline ratio (NYSE) rose for 10 months, turning up in August 1982 and topping out in June 1983. From the June 1983 high the A-D ratio has been going down steadily for 12 months as of June 1984. Thus the rise consumed 10 months and the decline has already carried for 12 months.

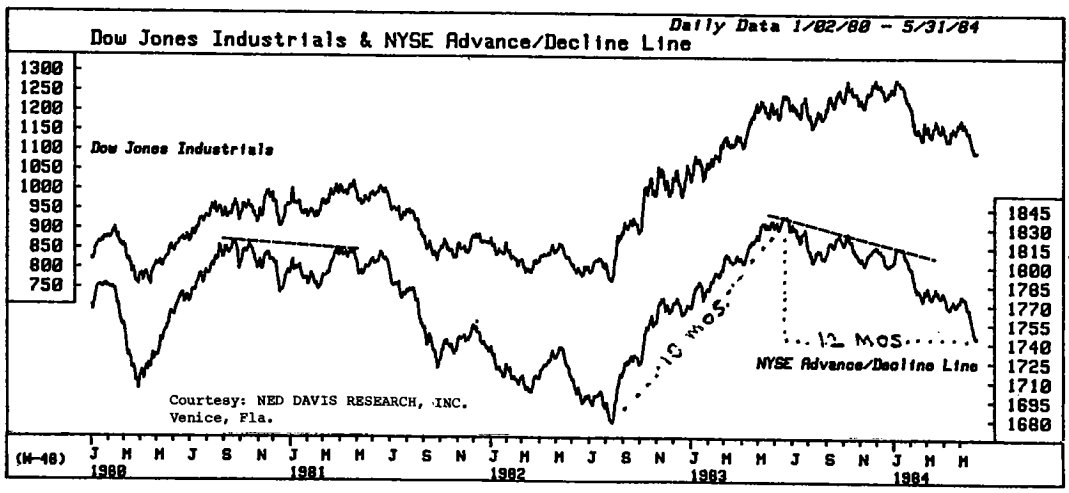
I stated that primary movements are usually the LONG movements while the corrections (although they can be violent) are usually the shorter movements. Thus, the fact that the A-D ratio is now in its 12th month of descent is ominous, I wrote. It confirms my thesis that the primary trend of the stock market is down.

My friend Marty Zweig (who does some of the best analysis in the business) was struck by my comments on breadth and went even further into the breadth study. Here's what Marty did. He took all instances back to 1926 (when breadth data was first available), and applied three criteria. (1) He identified every instance in which the A-D ratio advanced in a major move, then turned down and continued for an equal or longer period of time without recording a new high. In other words, if the A-D rose for 15 months and then turned down and in the ensuing 15 months failed to make a new high, that was a qualifying example.

(2) After the time limit has been met, Marty required that the A-D break down to a lower low than any since the top.

(3) The final condition was that Marty's Monetary Model had to be in the bearish mode, as it now is.

Amazingly, Zweig found that since 1926 there have been only four previous situations that fulfill these three criteria. I am including Marty's tabulations below, and as you can see, they are not pretty. Marty calls them "grizzly results," and he notes that even omitting the drastic 1929-30 instance the average drop was a fat 30%. The chart is courtesy of Ned Davis (Ned and Marty work together on a good deal of their research).




BEARISH A/D LINE, MONETARY SYNDROME: 1926 TO 1984

| A/D UPTREND | SELL DATE | DOW | % DROP TO LOW | MONTHS TO LOW |
|---|---|---|---|---|
| 4 Mo. 1929-30 | Oct. 1931 | 110 | -63% | 8 Mo. |
| 10 Mo. 1966-67 | June 1969 | 910 | -31% | 11 Mo. |
| 10 Mo. 1970-71 | Jan. 1973 | 990 | -42% | 23 Mo. |
| 6 Mo. 1980 | July 1981 | 930 | -17% | 13 Mo. |
| 10 Mo. 1982-83 | Apr. 1984 | 1170 | ? | ? |
| Average: | | | -38% | 14 Mo. |

**EVENTS:** (1) On the week ending June 15 the Dow lost 44.35 points, biggest loss since October, 1979. This came on a week when the bond market had its first decent rally in months (although it was widely held that if the bond market would only rally, the stock market would explode on the upside).

(2) Contra-Signals (37 Derby St., Hingham, Mass. 02043) reported that for the past five months they have received more bearish relative strength stock signals than in any five-month period since the service began publishing (and this is an old service).

(3) I am flabbergasted by the sheer number of hard money services that remain bullish on gold. The vast number of economists and stock market analysts continue to predict "inflation will heat up before 1984 is over". Considering that gold and inflation topped out four years ago in 1980, it is remarkable that so many cling stubbornly to the inflation thesis. They may be right, but I like market confirmation. It isn't there as of this writing.

(4) If one goes over the charts of the various no-load funds, it is clear that the great majority of them have had "their heads handed to them" in 1984 so far. Investors who thought no-load funds could beat a bear market have had to face the bitter truth. Many no-load funds have done considerably worse than the averages during this bear market. A few have shown spectacular losses of near 50%.

(5) Brokers naturally sell what's easiest to sell. Thus, many brokers are presenting the interest rate story and are pushing bonds. But the ranks of the brokers are thinning as many wire houses move to cut the fat. The old adage about the brokerage houses, "They hire at the highs and fire at the lows," has been proved again. Merrill Lynch changes presidents. Roundup time comes to the "thundering herd."

**INVESTMENT PHILOSOPHY:** I've stated this before, but I want to repeat it. There are only TWO (count 'em, two) real breaks that the US government gives its citizens today (and I'm talking about us citizens who *earn* a living).

(1) The 50% ceiling on personal income (which is down from 70% a few years back). When compared with most European countries, this 50% ceiling is actually a good deal. It means that you can keep half the money you make, and, of course, somewhat less if you live in a state like New York or California where they sock you with another tax of almost 10%. Nevertheless, the 50% ceiling is a good deal.

(2) The second good deal is the tax deferred pension plan, the IRA, the Keogh or the 401K. These allow you to build up dollars and compound those dollars, all tax deferred until you take your greenbacks out of the plan. Then Uncle Sam hits you with the taxes. But even if you lose over half your pension money in taxes, when you finally pull the money out (and if you have high state taxes you can lose more than half) these tax deferred plans are a good deal.

Those two items, then, are the only real "gifts" the government gives us as wage earners. And I've been thinking a lot about them. If you look at the history of taxes, you will note that taxes tend to go where the money is. And that makes me wonder (1) how long we will have a mere 50% ceiling on our incomes, and (2) how long will the government tax our pension plans in the current way? My guess is that we are (one way or another) seeing the lowest taxes of our lifetimes right now, and the government is going to figure out a way to hit those tax deferred plans for MORE. I am writing this paragraph via instinct and intuition, but if it happens you can tell your friends you read it here first.

Next, aside from collector's items or precious metals, there is only one way to get "outside" the taxing system and this is the municipal bond (preferably a bearer bond in your safe deposit box, with coupons you clip and present at the bank). The income from these bonds is free of federal taxes and (if from your state) also free from state taxes. Thus, if you compound the interest from these bonds you can grow rich fairly fast, and you keep

it ALL. Many revenue bonds of A or A1 quality are now yielding around 12% in the longer end, and at that rate your money doubles in less than seven years–with no taxes to pay. That's as good a deal as I think you can get today (compare that with stocks).

For instance, if you buy 10 shares of each of the Dow stocks you can hope to see your investment double in seven years (at a 10% per year total return basis), but even if it does (and that's no certainty), you will pay capital gains on the increase. But compound interest is no speculation -- it's a mathematical certainty, assuming the system survives.

The question is asked, "Can the government cancel the tax-exempt status of the municipal bond?" My answer is no. If the government tried, the case would hit the Supreme Court, and it would go against every tenet of the legal contract as we know it. Secondly, of course, an attack on muni bonds would bankrupt every city, county and state in the nation.No, muni bond interest will remain tax-exempt. Nobody is even hinting otherwise.

*Question:* Russell, I hear a lot about the flat tax and so forth. What do you think will happen to taxes next year?

*Answer:* I think the odds favor the current system remaining–with revisions. I say that because the "tax industry" includes a huge vested interest of IRS agents, lawyers, tax accountants, tax shelter people, etc. A veritable army lives on the tax system in this nation.

One dim possibility is a flat tax of say 30% with a national sales tax pinned on top of that. But remember–the government needs MORE money, not less, and any tax system revision will be calculated to bring in more money. Also, there are far more lower middle income and low income voters than wealthy voters. Therefore, higher taxes will entail higher taxes to the wealthy. You can count on it.

**DIGESTS:** I've received a lot of letters from subscribers recently all asking my opinion of investment advisory digests. That's a tough question, but I do have an opinion of them, so here goes.

But first, I've written about this off and on for over 25 years, but I'll repeat it here. I don't believe one person can benefit over any period of time from the advice of another. The reason is that everyone who invests money has his own personality, his own fears, his own needs and his own way of responding to advice. Let me put it another way: in 25 years of dealing with investors and advisors, I have never met anyone who said to me, "Russell, I have followed Mr. X for the past ten years, and I am very happy with the results. I've done nothing but make money with X, and I'll follow him until I stop making money with him." Now there might be exceptions to this statement, but I've never met them.

In my opinion, if you're not willing to learn the business of investing, if you're not willing to explore your own psyche and idiosyncrasies, if you're not willing to develop a philosophy that works for YOU, then you will never take away more than you invest in this business.

Investment advisors can help, they can supply ideas, but they all make mistakes, they all blow hot and cold. In my opinion the best advisors supply ideas and concepts and thoughts and facts. But as to following an advisory blindly, forget it. You'll probably lose your shirt.

Lately, a new breed has arisen. The digests. Some of these new publications simply digest paragraphs from other services, and a few keep running tabulations regarding how various services are doing. Frankly, I don't have much use for the digests. I don't find them useful, and I don't know what they accomplish. There must be a dozen different digests now, and one fellow (as a joke) now sends out a "Digest of Digests." A well known advisory service is suing a leading digest because he says that the digest messed up the statistics and caused him great harm. Personally, I don't like to be quoted in the digests, and I try to keep out of them. My work is mine, and I really don't want anyone else digesting, abbreviating or otherwise messing with what I write.

**MONEY THOUGHTS:** The 10-year return (appreciation plus dividends) on the Standard & Poor's 500 stock index. . . . 10.8% (Taxable). Current yield on the Treasury 13 3/8 bond of 2001 . . . . 13.58% (Taxable by Fed but not state). Yield on California General Obligation bonds of 2000 . . . . 9.6% (free of state and federal taxes if you are a Calif. resident).

Over any ten-year period it is difficult for a money manager to average 10% appreciation compounded. Thus, you can immediately see the dilemma of the stock buyer in this area. He needs one heck of a lot of growth over the next ten years to even equal the current return on bonds.

Second thought: municipal bonds usually sell for anywhere from 92% (on the high side) to 75% (on the low side) of Treasury bonds. Currently, the ratio is down to 70%. This means that (1) either muni bonds are very expensive compared with Treasury bonds or (2) Treasury bonds are very cheap compared with muni bonds or (3) investors see something in munis that make them worth a lot more than Treasury bonds on a historical basis.

What could be the thinking here? For one thing, the 50 states are running a surplus on balance (about a $60 billion annual surplus) while the Treasury is running horrendous deficits. The market could be saying that muni bonds are now safer than T-bonds.

The states can't print money with which to pay bondholders, but it is equally true that the states don't have to deal with a $300 billion dollar military budget.

The bond market could be telling us that taxes are going up, particularly at the federal level, and a tax free dollar from a muni bond is going to be worth more than a taxable dollar from a T-bond. Take your choice, but it's worth pondering.

Final thought: an investor in the 50% tax bracket buys a muni bond yielding 10%. He would have to make a pre-tax 20% to equal that (actually 21% or more if he lives in a high tax state like New York or California). In five years the investor is theoretically home free at the 10% non-taxable rate since he would have to earn 20% for five years (5 x 20% equals 100%) in order to equal the non-taxable 10%.

**NOTES & QUOTES:** At the London Conference and elsewhere throughout the world President Reagan has been hounded about the "American deficit." He has been hounded so many times, that he seems to have developed a new or pat

answer for each interviewer. In fact, the New York Times (June 9) compiles a list of Mr. Reagan's stock answers regarding the outrageous deficits. Here they are:

1) "The down payment is coming."
2) "Deficits aren't really so bad."
3) "High interest rates may be good for you–our deficit spending has financed your recovery" (this said to Europe).
4) "It's all Congress' fault. They didn't approve all my budget cuts."
5) "It could be worse; if Jimmy Carter was still in office the deficit would be $90 billion higher."
6) "Inflation has been halved, we're having a recovery, so why complain?"
7) "The deficit problem is exaggerated, and the size of the deficit has been overstated."
8) "You're just as bad as we are; the US deficit as a percentage of GNP is no worse than the whole European deficit situation taken together."
9) "It can be managed." This is Treasury Secretary Regan's favorite line.
10) Finally, when all else fails, President Reagan states that "We really do hate deficits and we have opposed them all along."

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As a follow-up to the piece I included in the last Letter by Felix Royhatan, it now appears that "greenmail" is the way to go in the world of corporate finance. Consider this: Disney agreed to pay financier Saul Steinberg $32 million for his 12.2% stake in Disney and his promise not to invest in Disney for the next ten years. The Steinberg threat was reinforced by MGM controlling stockholder Kirk Kerkorian's announced intention of buying 49% of Disney (actually, Kerkorian owned no Disney shares).

So for almost one-third of a billion dollars, Disney bought back its own stock. As far as I am concerned, Disney was stupid, the stockholders got raped, the company is now worth less (minus the third of a billion) and Steinberg picked up a $32 million profit plus $28 million for expenses. As an aside, Disney recently paid out $530 million to buy a Florida land company and Gibson, a greeting card company. Good luck, Mickey Mouse.

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Latest tax info: The flat tax could be out. "Buck" Chapoton, tax policy chief at the Treasury, states that the flat tax is "unrealistic because of the dramatic shift in the tax burden it would cause from upper-to-lower and middle-income taxpayers." Chapoton would like to convert the income tax into a consumption tax, exempting savings and taxing borrowing and spending–or levying a value-added or even a national sales tax.

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Defense: It is now generally recognized that the US is not going to spend as much on conventional military as Russia. So it is gradually dawning on our military that we must move toward leadership in space. If American technology and problem-solving is harnessed correctly, we can do it. The problem, however, is that the military, Congress and most Americans are still thoroughly rooted in "last year's defenses" (battleships, tanks, manned planes, etc).

Robert S. Cooper, director of the Defense Advanced Research Projects Agency, is in favor of forming a national space command as a major new arm of the military. I agree with him 100%. It has got to be done. Here is an excerpt from a recent speech given in San Diego by Cooper:

**By Robert S. Cooper**

This country is not ready to spend its way to equivalence with the Soviet Union in general purpose forces and probably not in strategic forces, either. The Soviets are spending at a rate which, if it continues and if we continue to expend what the country will agree to in the Defense Department in the 1990s, by the turn of the century the Soviets will have what is a dominant force against us.

That's the view in the Defense Department today – across the professional military people and the political appointees.

The defense budget is a third of the total federal budget, which is approaching a trillion dollars. In a $4 trillion economy, that represents about 7 percent of gross national product. And that's not enough.

Why isn't it enough? If you try to put what the Soviets appear to be spending, in terms of human effort in the Soviet Union and the capital that they have, to produce defense products of one sort or another and for the support of their very large standing military forces, the estimates range anywhere from 13 percent to perhaps as great as 19 percent of their gross national product. Their gross product is only about half that of this country, so an equivalence in spending would be at roughly 14 percent. If they are truly spending 19 percent, then they're probably spending half again as much as the U.S.

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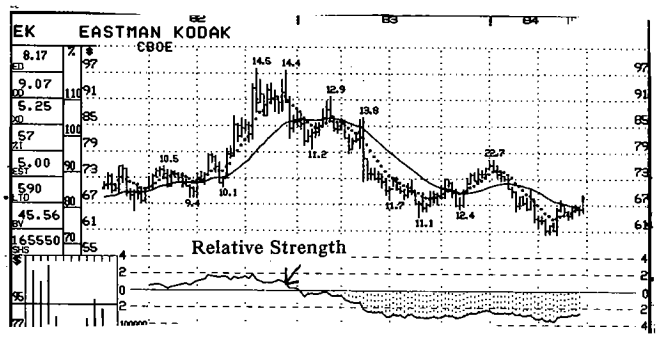
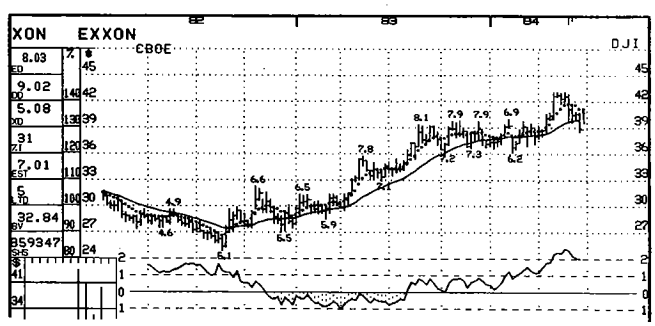
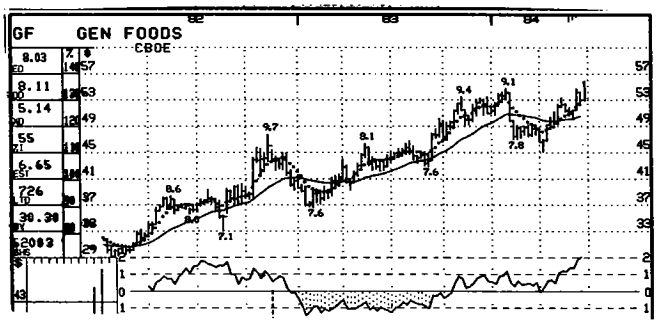
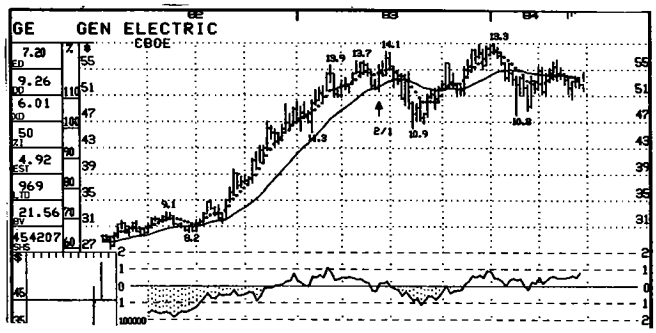
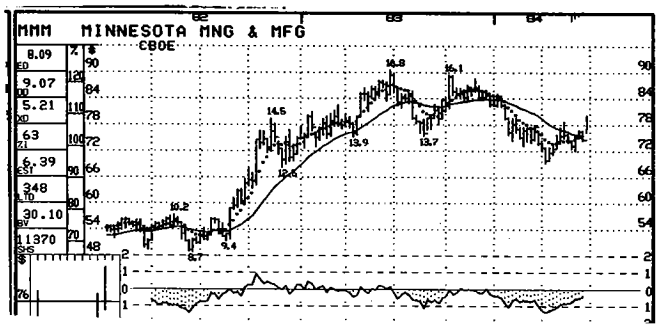
Superior Action: All right, let's get onto something happy. The six charts shown (charts courtesy of Mansfield, 1973 Kennedy Blvd., Jersey City, NJ 07306) are by my reckoning the strongest stocks in the Dow. All six show superior relative strength and all six are above their longer-term moving average. Of the six, the strongest of all is General Foods. The stock is defensive, has lots of cash, good management and in the right business. Here's a stock that has bucked the bear market–all the way.

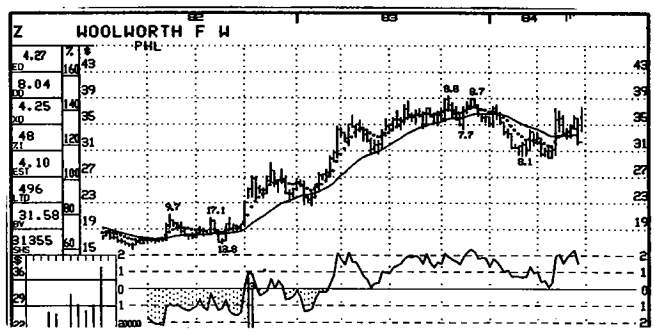


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I'm embarrassed to say this, but it's something I've known for a long time. San Diegans are among the nation's cheapest people, they will only spend money on two items–their homes and their cars. But they will walk ten miles for a bargain. For instance, two weeks ago the Western League leading San Diego Padres (baseball) offered free beach towels for all who would come to see a given game. A paying crowd of 48,805 showed up. The crowd on the day before the great towel giveaway was 14,002. The crowd on the day after the giveaway was 18,723. Maybe San Diego is a city of beach bums, not sports fans. But they do sell out for the football games.

**NEXT MAILING: July 11**

Ratings: Some of the top ratings for GO (General Obligation) bonds are given to Western cities. S & P gives San Diego an AA rating, Dallas gets a top AAA, and San Antonio gets AA plus. To show you the difference between cities, San Diego's direct debt per capital is a tiny $23 and the only other city in this class is LA with $57. Highest in the nation is NYC with $938 per person.

**GOLD:** As of January 1, all coin dealers will be required to report to the IRS all sales of Krugerrands, Maple Leafs and Mexican 1 ounce gold coins. Thus, the era of "free" gold trading slowly comes to an end. Next, it wouldn't surprise me to see the tax law changed on gold, with all gains counted merely as income instead of capital gains.

Over the past year, however, gold-holders' least worry has been taxes on profits. The reason is simple–there haven't been any profits. Hard money guys tell me, "Russell, you've been cool to gold for the last four years, and it's pessimists like you who have held gold down." And I tell them, "You've got it wrong. Gold has been in a bear market since 1980, and it's the gold action itself that has made me cool. I've got nothing against gold, I loved it for 20 years prior to 1980. I was advocating (in 1960 and thereafter) buying gold shares before 95% of the people in the advisory business knew what gold was."

But I keep insisting that when you buy an item you must have the trend behind you or else have a hell of a good reason for doing otherwise (like buying a home). Right now, I still see the trend of gold as at best neutral and at worst still within the throes of a primary bear market. After all, the world is in a bad way, debt is eating up the globe, and everyone tells us that the debt must be inflated away. But gold seems immune to inflation fears, and even a five-page "world debt crisis" special edition of the WSJ (June 22) didn't do anything for gold.

Again, I'll say (and C.V. Myers and I are almost alone on this) that the debt situation is basically deflationary. Ultimately, it is going to spell "wipe out" for assets. When billions of dollars go down the drain that creates a shortage of liquidity. Yeah, I know, the Fed can print up more liquidity. But if they do, there could be a run on the dollar, or there could be a problem of just panic distrust. That's also deflationary. Put it this way, if the great tide has turned deflationary then all the printing presses in the world aren't going to turn it. The liquidation will wipe out dollars faster than the Fed can get the public to take more.